United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

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IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 74-1795

GEORGE J. SCHONHOLTZ,

Plaintiff-Appellant,

-against-

AMERICAN STOCK EXCHANGE INC., RAMSAY, RE, FARRELL, ROCHLIN & ERDMAN and BEAR, STEARNS & CO.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANTS-APPELLEES RAMSAY, RE AND BEAR, STEARNS

PRELIMINARY STATEMENT

This brief is respectfully submitted on behalf of defendant-appellees Ramsay, Re, Farrell, Rochlin & Erdman ("Ramsay, Re") and Bear, Stearns & Co. ("Bear, Stearns") in response to the brief submitted by plaintiff-appellant

("plaintiff"). Plaintiff appeals from the decision dated May 6, 1974 of the United States District Court for the Southern District of New York (by the Honorable Morris E. Lasker) (A-17-24)* granting defendants' motions, pursuant to Rule 12(b) of the Federal Rules of Civil Procedure, to dismiss the complaint for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter. [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,539.

STATEMENT OF THE CASE

On or about August 24, 1973, plaintiff brought the present action on behalf of all short sellers of Levitz Furniture Corporation ("Levitz") common stock during the period from October 20, 1969 through August 24, 1971. In the complaint, plaintiff names the American Stock Exchange (the "AMEX"), Ramsay, Re (alleged to be the AMEX specialist in Levitz common stock**) and Bear, Stearns (alleged to be directly or indirectly in control of Ramsay, Re) as defendants and purports to allege violations of Rules 170 and 177 of the AMEX, 2 CCH American Stock Exchange Guide ¶¶ 9310, 9317, Section 10(b) of the

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* Numerical references preceded by "A" are to the Joint Appendix.

** In fact, there never has been an entity doing business under the name of Ramsay, Re, Farrell, Rochlin & Erdman.

Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b) (1970), and Rule 10b-5, 17 C.F.R. §240.10b-5 (1974), promulgated thereunder. (A-3-8).

Construing the complaint most liberally in favor of plaintiff,* the alleged "facts" which plaintiff claims state a cause of action against Ramsay, Re and Bear, Stearns are as follows:

> 1. During the relevant period, of the 5,573,895 outstanding shares of Levitz common stock approximately 2 million shares were held by "[o]fficers of Levitz, their relatives, and a partnership of which certain of the controlling persons of Levitz were partners" and approximately 2.2 million shares were held by institutional investors (Complaint, ¶ 4, at A-6),
>
> 2. The floating supply of Levitz common stock available to the investing public (1.3 million shares) was inadequate to insure a fair, honest and orderly market and resulted in trading at artificially high prices (Complaint, ¶¶ 4, 5, at A-6-7),
>
> 3. Defendants Ramsay, Re and Bear, Stearns knew or should have known of the inadequacy of the float, should not have allowed the stock to trade at artificially inflated prices and should have promptly suspended trading therein (Complaint, ¶¶ 2(a)(iv), 8, at A-4, 7-8),

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* Many of the factual assertions contained in plaintiff's Brief on Appeal have no basis in the allegations of the complaint. See, e.g., plaintiff's assertion that Ramsay, Re and Bear, Stearns "impliedly misrepresented" the 1.3 million share float in Levitz common stock to be adequate. (Plaintiff's Brief at 30-31).

4. Plaintiff and all other short sellers of Levitz common stock during the relevant period were damaged when they covered their short positions by purchasing stock at artificially high prices created by the inadequate float (Complaint, ¶ 7, at A-7), and

5. Had plaintiff and all other short sellers of Levitz common stock during the relevant period been adequately informed by defendants of the material facts as to the inadequacy of the float, they would not have sold short. (Complaint ¶ 10, at A-8).

On November 27, 1973, prior to answering the complaint, defendants Ramsay, Re and Bear, Stearns moved, pursuant to Rule 12(b) of the Federal Rules of Civil Procedure, to dismiss the complaint. (A-9-10). On November 28, 1973, defendant AMEX made a similar motion. (A-11). On May 6, 1974, the Honorable Morris E. Lasker, holding that plaintiff had failed to state a claim, granted said motions and dismissed the complaint as to all defendants. (A - 17-24).

ARGUMENT

The court below correctly held that plaintiff has failed to state a claim against either Ramsay, Re or Bear, Stearns for violation of AMEX Rule 170 or AMEX Rule 177. AMEX Rules 170 and 177 are irrelevant to the allegations of the complaint and form no basis whatsoever for the implication of the specialist's duties which plaintiff contends arise therefrom.

But, as the court below held, even if plaintiff had alleged violations of these Rules, stock exchange rules are not actionable per se in federal court. Although certain stock exchange rules may be actionable when the alleged violations thereof are coupled with sufficient allegations of fraudulent conduct, plaintiff has failed to allege fraudulent conduct sufficient either to sustain a Rule 10b-5 claim or to render AMEX Rules 170 and 177 actionable. Thus, the court below correctly dismissed the complaint.

POINT I

The Court Below Correctly Held That Plaintiff Has Failed to Allege Any Actionable Breach of a Duty Arising Under AMEX Rule 170 or AMEX Rule 177.

As the court below found, there are two separate and alternative reasons why plaintiff has failed to allege any actionable breach of a duty arising under AMEX Rule 170 or 177. First, plaintiff has failed to set forth a violation of either Rule 170 or 177. Second, even if plaintiff had alleged such a violation, violations of stock exchange rules are not actionable per se in federal court in the absence of sufficient allegations of fraudulent conduct.

A. The Allegations of the Complaint Are Insufficient to State a Violation of Either AMEX Rule 170 or AMEX Rule 177.

In his Brief on Appeal, plaintiff asserts that he has pleaded facts which, if proven, will establish a claim for violation of AMEX Rules 170 and 177. (Plaintiff's Brief at 16). Plaintiff declines, however, to identify such alleged facts. As the court below found, examination of the complaint reveals that plaintiff has set forth no factual allegations whatsoever that are relevant to Rules 170 and 177.*

Plaintiff contends that Rules 170 and 177 place upon the specialist a duty to report to the public its opinion of the adequacy of the float of a given stock and to suspend trading on the AMEX in that stock when, in the specialist's opinion, the float is inadequate. Such a contention is without merit.

Even a cursory examination of Rule 170 reveals that insofar as it refers to the maintenance of a fair and orderly market it only concerns a specialist's duties in dealing for his own account. This Rule precludes any dealings for a specialist's own account not reasonably necessary to the maintenance of a fair and orderly market [Rule 170(c)], and, conversely, requires that a specialist "engage in a course of

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* For the convenience of the Court, AMEX Rules 170 and 177 are set forth in full in the Appendix to this Brief.

dealing for his own account to assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market . . .," [Rule 170(b)]. Rule 170 imposes no general duty to maintain a "fair and orderly market," but imposes only a specific duty to trade (or not trade except) in furtherance of a fair and orderly market.

In addition to the plain language of Rule 170, Section 11 of the Exchange Act, 15 U.S.C. § 78k (1970), the statutory source of the specialist's duties, confirms that the duty to maintain a fair and orderly market arises only in connection with the specialist's dealing for his own account. Section 11(b), 15 U.S.C. §78 k(b) (1970), provides:

> "(b) When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit . . . a member to be registered as a specialist. If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market . . .." 15 U.S.C. § 78k(b) (1970) (emphasis added).

Moreover, both the legislative and the regulatory history of the specialist rules conclusively demonstrate that concern over the dealer function of the specialist is the source of the duties imposed by Rule 170. See, e.g., SEC, Report on the Feasibility and Advisability of the Complete Segregation of the

Functions of Dealer and Broker (1936); SEC, Staff Report on Organization, Management and Regulation of Conduct of Members of the American Stock Exchange (1962) ("AMEX Report"); SEC, Report of Special Study of Securities Markets, Part 2, 57-171 (1963) ("Special Study"). Similarly, the Case Study on Regulation of Specialists on the New York and American Stock Exchanges ("Specialist Case Study"),* which contains an extensive legislative history of Section 11(b), shows that the statutory "fair and orderly market" language was aimed at resolving the particular problem of regulating the specialist's ability to deal for his own account. Id. at 4 n.13.

Inasmuch as the allegations of the complaint do not even relate to the specialist's dealing for his own account, they cannot be construed to set forth a violation of Rule 170. Plaintiff does not allege, and would have no basis to allege, that Ramsay, Re failed to "engage in a course of dealing for [its] own account to assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market. . . ." [Rule 170(b)]. Similarly, plaintiff does not allege that Ramsay, Re actively engaged in a course of dealing for its own account which was

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* Appendix to Hearings of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs on Self-Regulation in the Securities Industry, Part 4, 93rd Cong., 2d Sess. (1972).

not reasonably necessary to the maintenance of a fair and orderly market.*

Neither Rule 170 nor 177 places a duty on the specialist to suspend trading, as plaintiff contends, for inadequacy of supply or for any other reason.** Moreover, as the court below noted, the relevant suspension and delisting policies of the exchange presently provide that the AMEX may suspend trading for reason of an "inadequate float" only where

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* The SEC proceeding cited by plaintiff, In the matter of Re, Re & Sagarese, SEC Securities Exchange Act Release No. 6900, [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,868 (Sept. 21, 1962), illustrates a course of such dealings beyond that permitted, and in furtherance of a specific fraudulent scheme. Specifically, the court in a connected case noted that "vital participants in this [fraudulent] distribution were the Res, who engaged in transactions . . . far beyond the limited scope of activity allowed specialists in connection with maintenance of a fair and orderly market." Pettit v. American Stock Exchange, 217 F. Supp. 21, 24 (S.D.N.Y. 1963). In contrast here, plaintiff concedes that Ramsay, Re could not have cured an "inadequate supply" of the magnitude alleged by plaintiff; in paragraph 9 of the complaint he alleges that "Ramsay, Re was unable to maintain a fair and orderly market in Levitz common stock." (emphasis added) (A-8).

** With reference to plaintiff's contention that the Rules impose a duty to suspend where large blocks of a stock are held by institutional investors, it should be noted that the Special Study considered the specialist's duties in light of a substantial increase in institutional investments on the exchanges. Special Study at 128-133. While a specific recommendation of a change in specialist rules resulted from this consideration (increased capital requirements), no mention was made of any duty to suspend when such institutional investments reached a given level. Special Study at 167-171.

"the number of shares publicly held (exclusive of holdings of officers, directors, controlling shareholders or other family or concentrated holdings) is less than 200,000."* 2 CCH American Stock Exchange Guide ¶ 10,051. In light of this official standard for suspension, plaintiff's contention that defendants had a duty to suspend where "only" 1.3 million shares were available to the investing public cannot set forth a cause of action.** As the court below noted, plaintiff's own allegations establish that defendants complied with the official AMEX suspension policy. (A-20).

Furthermore, Rule 170 provides no basis for plaintiff's apparent assertion that Ramsay, Re was obligated to prevent the two year "inflationary" upward trend of Levitz stock prices. The AMEX, in its interpretation of Rule 170, has made it clear that

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* These guideline figures were increased on April 13, 1972; during the relevant period in this action (1969-71) the minimum standard was even less: 150,000 shares. American Stock Exchange Company Guide 3 (Supp. #2, May 15, 1973).

** It is particularly significant, in light of the AMEX suspension policy, that plaintiff does not contend that as a short seller he was unable to "cover" due to an inadequate float. Rather, plaintiff's basis for complaint is that he was only able to "cover" at a price higher than that at which he sold. Thus defined, a short seller is always confronted by an "inadequate" supply in a bull market. Presumably, therefore, acceptance of plaintiff's proposed duty would require the specialist to suspend trading whenever the overall demand for his stock exceeds the supply.

a specialist has no such duty:

> "As a dealer, [the specialist] is obliged, insofar as reasonably practicable, to purchase and sell securities for his own account in order to help maintain a fair and orderly market. His aim is to provide a continuous auction market throughout the trading day, with minimum price changes between transactions. The specialist does not by his own activities determine the trend of stock prices. Rather, the price at any given moment is determined fundamentally by the balance of public buy and sell orders." (emphasis added) American Stock Exchange Company Guide § 411 (1973).

Similarly, the SEC interpretative sources make it clear that the Rules impose no duty on specialists to "stabilize" in the sense plaintiff contends (Plaintiff's Brief at 30), i.e., prevent an overall decline or rise in market prices of his stock. See e.g., Special Study at 123 (". . . a private dealer system cannot and should not be expected to stabilize the market (in the sense of holding price levels or stemming price trends) . . . the impact of specialists' trading is probably minimal in affecting overall market movements . . .").*

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* The same sources make it equally clear that the concept of a "fair and orderly market" is not related to the long-term variations in supply and demand implicit in plaintiff's allegations (of a two-year "inadequate" supply, i.e., a two-year "bull market," in which demand for Levitz stock was higher than supply). Rather, the concept of a "fair and orderly market" is related to short-term trading necessary to fill "gaps" in price movements (i.e., to meet a "buy" order at market price, when there is no matching "sell" order at the moment close to the last transaction). See Specialist Case Study at 3; AMEX Rule 170(d). Consequently, plaintiff's allegations of "artificially inflated prices" do not even allege the absence of a fair and orderly market.

Plaintiff's reliance on Rule 177 (set forth in full in the Appendix to this Brief) is as misplaced as is his reliance on Rule 170. Rule 177 relates solely to reporting to Floor Officials and provides that a specialist report to a Floor Official any unusual activity, unusual transactions, existence of options or material information which he believes may materially affect either the financial structure of the issuer or the market in which he specializes. Inasmuch as plaintiff does not allege a failure on the part of Ramsay, Re to report to a Floor Official or even make a single reference to Floor Officials, plaintiff's allegations cannot possibly set forth a claim under Rule 177.

Thus, the court below correctly held that plaintiff has failed to plead facts which, if proven, would establish a claim for violation of either AMEX Rule 170 or AMEX Rule 177.*

B. Even if Plaintiff Had Alleged Violations of AMEX Rules 170 and 177, Such Alleged Violations Would Not Be Actionable in Federal Court.

Even if plaintiff had alleged violations of AMEX Rules 170 and 177, such alleged violations per se would not suffice to confer subject matter jurisdiction on the court below. As the court below noted. there appears to be no

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* It should be noted that even if plaintiff had alleged violations of Rules 170 and 177, it is doubtful that plaintiff and his class would have the requisite standing to maintain an action based on violation of these Rules. Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973).

decision holding that violation of a stock exchange rule is per se actionable under the federal securities laws. (A-23). Moreover, it does not appear that a violation of either Rule 170 or Rule 177 has ever been held to be actionable in federal court. Plaintiff's contention that this Court should create such a novel cause of action lacks merit.

Although dictum in Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966), suggests that some stock exchange rules may be held to be actionable provided that they meet certain criteria*, Rules 170 and 177 do not meet the relevant criteria. Under Colonial Realty, a court in considering the actionability of the violation of a stock exchange rule must "look to the nature of the particular rule and its place in the federal regulatory scheme . . ." 358 F.2d at 182. As the Third Circuit has recently clarified, Colonial Realty requires that an actionable stock exchange rule be "part of the federal scheme to prevent fraudulent practices and protect investors." Landy v. FDIC, 486 F.2d at 166.

Clearly Rules 170 and 177 do not meet the criteria for actionability. Although the statutory watchword from

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* The Colonial Realty court held that no cause of action had been stated against the defendant there for violation of Section 6, Article XIV of the New York Stock Exchange Constitution, 2 CCH New York Stock Exchange Guide ¶ 1606. 358 F.2d at 183.

Section 11(b) of the Exchange Act, "fair and orderly market," appears in Rule 170,* this Rule was not designed either to protect investors from fraudulent practices or to be civilly enforceable. As the SEC stated with regard to both Rule 170 and Rule 177:

> "These rules, all of which were adopted by the Exchange, were designed to place basic record-keeping and anti-speculation requirements on the specialists." AMEX Report at 22.

Thus, these Rules do not "play an integral part" (Colonial Realty, 358 F.2d at 182) in any regulatory "scheme to prevent fraudulent practices."

There is an additional reason why alleged violations of Rules 170 and 177 should not be held actionable in the present case. For a stock exchange rule to be actionable in federal court, there must be a concommitant allegation of fraudulent conduct. As the court below stated, allegations of stock exchange rule violations:

> " . . . have been held to state a claim only where coupled with sufficient allegations of fraud on the investor. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 410 F.2d 135 (7th Cir. 1969), cert. denied, 396 U.S. 838 (1969)

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* Plaintiff's conclusory allegation that Ramsay, Re failed to maintain a fair and orderly market in Levitz stock cannot suffice, for Colonial Realty held that "mere recitation to the statutory watchword by an aggrieved investor" does not confer subject matter jurisdiction on a federal court. 358 F.2d at 183.

(N.Y.S.E. Rule 405, the "know your customer rule" actionable in conjunction with allegations of fraud), Aetna Casualty & Surety Co. v. Paine, Webber, Jackson & Curtis, '69-'70 Transfer Binder, CCH Fed. Sec. L. Rep. ¶92,748 (N.D. Ill. 1970) (alleged violation of Rule 405 amounting to mere negligence failed to state a claim) accord, McMaster Hutchinson & Co. v. Rothschild & Co., 1972-73 Transfer Binder, CCH Fed. Sec. L. Rep. ¶93,541 (N.D. Ill. 1972); Bush v. Bruns Nordeman & Co., 1972-73 Transfer Binder, CCH Fed. Sec. L. Rep. ¶93,674 (S.D.N.Y. 1972) (alleged violations of Rule 405 "inextricably linked" with §10(b) claims stated a claim)." (A-23).

This holding is in accord with Second Circuit law, for this Court stated in Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (citing Colonial Realty) that it is "insufficient to allege mere negligence . . . breach of contract or breach of a stock exchange rule." 448 F.2d at 445. Similarly, the court in Gurvitz v. Bregnan & Co. [Current] CCH Fed. Sec. L. Rep. ¶ 94,756 (S.D.N.Y. Aug. 6, 1974), held that "if plaintiffs cannot sustain federal jurisdiction under Section 10(b) or Rule 10(b)(5) promulgated thereunder, they cannot independently sustain jurisdiction under [NASD Rules]." Id. at 96,490. Since, as the court below held, plaintiff has failed to allege the requisite fraudulent conduct on the part of Ramsay, Re and Bear, Stearns (see Point II B of this Brief, infra), federal jurisdiction cannot be predicated on alleged violations of AMEX Rules 170 and 177.

Plaintiff places heavy reliance on the SEC's adoption in 1964 of Rule 11b-1, 17 C.F.R. § 240.11b-1 (1974), insofar

as it requires exchanges to have rules incorporating the "affirmative" obligation of the specialists to deal. (Plaintiff's Brief at 20-22.) Such reliance is misplaced. The SEC has acknowledged that special care was taken in drafting Rule 11b-1 precisely to avoid the possibility of civil liability for violation of the highly subjective and uncertain standards. Thus, an SEC official recently stated that "the inherent uncertainty in the practical application of the general standards of 'affirmative' and 'negative' specialist obligations, and the subjective basis of judgments thereon" made imposition of civil liability for failure to conform to such obligations particularly inappropriate. Specialist Case Study at 68 (Comments of SEC Commissioner Phillip A. Loomis, Nov. 13, 1972). Consequently, far from providing a basis for civil actionability of specialist rules, SEC Rule 11b-1 expresses the SEC's judgment that such liability should not be imposed on specialists.

Plaintiff has the burden of persuasion that federal liability should be imposed for Rules 170 and 177, which is "a considerably heavier burden of persuasion than when the violation [for which liability is sought] is of the statute [the Exchange Act] or an SEC regulation." Colonial Realty, 358 F.2d at 182. This burden has not been met.

POINT II

The Court Below Correctly Held That Plaintiff Has Failed to State a Claim Against Ramsay, Re and Bear, Stearns Under Section 10(b) of the Exchange Act.

Plaintiff contends that even if his allegations do not state a claim for violation of AMEX Rules 170 and 177, these allegations nevertheless state a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. As the court below found, such a contention is wholly lacking in merit. Federal jurisdiction cannot be predicated on "mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b-5," Shemtob v. Shearson, Hammill & Co., 448 F.2d at 444. See also Segal v. Gordon, 467 F.2d 602 (2d Cir. 1972). Fraud must be stated with particularity. Fed. R. Civ. P. 9(b).

A. Plaintiff's Allegations Fail to State a Rule 10b-5 Claim, For They Are Predicated on Nonexistent Duties of a Specialist.

Examination of the complaint reveals that plaintiff has merely pinned a Rule 10b-5 label on his nonactionable allegations of stock exchange rule violations in the hope of conferring jurisdiction on the court below. Such a guise must fail.

Plaintiff's purported Rule 10b-5 claims, like his purported AMEX Rules 170 and 177 claims, are predicated on the existence of certain duties on the part of the stock exchange specialist. Specifically, plaintiff argues that the specialist has a duty to inform the public of its opinion as to the

adequacy of the float in a given stock and to suspend trading when, in its opinion, such float is inadequate. According to plaintiff's novel theory, failure to inform the public of the inadequacy and to suspend trading constitutes an "implied misrepresentation" on the part of the specialist as to the adequacy of the float.

Even assuming arguendo that Ramsay, Re and Bear, Stearns did have actual knowledge of the number of shares in the Levitz float and had formed the opinion that such float was inadequate,* the law is clear that they were under no duty to disclose such opinion to the public** or to suspend trading. As shown in Point IA of this Brief, supra, neither the AMEX nor the SEC imposes such duties on a specialist.

Plaintiff contends that the "book," which merely contains orders to buy or sell to be executed "away from the market," allows a specialist to make a "reasonably accurate estimate" of the supply and demand balance of his stock. (Plaintiff's Brief at 29). While conceding that such information is "legally secret," plaintiff reaches the illogical conclusion that Rule 10b-5 requires the specialist to dis-

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* In fact, other than knowing that the float was sufficient as a matter of law to allow the stock to continue to be listed with the AMEX, Ramsay, Re and Bear, Stearns had no basis for knowing the amount of the float or for forming an opinion as to the adequacy thereof. (See pp. 9-10, supra).

** It is well settled that mere opinions are not information required to be disclosed under Rule 10b-5. Arber v. Essex Wire Corp., 490 F.2d 414, 421 (6th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1308 (2d Cir. 1973) (en banc).

close to the public this very information. Id. The imposition of such a duty under Rule 10b-5 would, however, directly contravene AMEX Rule 174, which provides:

> "No member acting as a specialist shall, directly or indirectly, at any time disclose to any person other than a Floor Official or authorized Exchange official: (a) any information in regard to orders entrusted to him as a specialist. . . ." (emphasis added) 2 CCH American Stock Exchange Guide ¶ 9314.

Inasmuch as Ramsay, Re and Bear, Stearns did not have the duty to inform the public as to their opinion of the adequacy of the float and to suspend trading when, in their opinion, such float was inadequate, no "implied misrepresentation" can ensue from their failure to exercise such "duties." As the court below correctly held, plaintiff's attempt to predicate a Rule 10b-5 claim on breach of nonexistent duties must fail.

B. Plaintiff's Allegations Fail to State a Rule 10b-5 Claim, For the Requisite Degree of Fraudulent Intent is Lacking.

There is an additional reason why plaintiff's allegations do not state a Rule 10b-5 claim. Assuming arguendo that Ramsay, Re and Bear, Stearns did have the duty to inform the public as to their opinion of adequacy of float and to suspend trading when, in their opinion, the float was inadequate, plaintiff's allegations of failure to exercise such duties cannot state a Rule 10b-5 claim, for the requisite element of fraudulent intent is lacking. As Judge Mansfield stated,

jurisdiction cannot be invoked under Section 10(b) and Rule 10b-5:

> ". . . in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence . . ." Shemtob v. Shearson, Hammill & Co., 448 F.2d at 445.

Similarly, various Second Circuit courts have recently held that a complaint failing to allege scienter or intent to defraud is insufficient because it "ignores the plain language of the [Exchange Act] provisions which prohibit deceptive or fraudulent devices in connection with the purchase and sale of securities." Independent Investor Protective League v. New York Stock Exchange, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,323 at 95,115 (S.D.N.Y. Dec. 12, 1973). See also Lanza v. Drexel & Co., 479 F.2d at 1305; 3 L. Loss, Securities Regulation at 1766 (2d ed. 1961); 6 L. Loss, Securities Regulation at 3883-85 (1969 Supp.).

Plaintiff has not alleged a fraudulent scheme or knowing participation therein by either Ramsay, Re or Bear, Stearns.* Even assuming that defendants did breach the purported

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* In an attempt to embellish the allegations of the complaint, plaintiff has asserted additional conclusions in his Brief on Appeal, namely, that "price movements in Levitz stock were being artificially controlled" (Plaintiff's Brief at 16) and that Bear, Stearns "knew that a corner had developed" (Plaintiff's Brief at 38). Nowhere in the complaint has plaintiff alleged the existence of any scheme or conspiracy to "corner" the market in Levitz stock and/or control price movements. Mere allegation that institutional investors owned 2.2 million shares cannot overcome the need to allege and prove the existence of such a conspiracy.

duty to disclose their opinions and to suspend trading, plaintiff has, at most, alleged negligence.* In view of the AMEX standards for suspension noted above (see pp. 9-10, supra), plaintiff's present assertion that defendants were "reckless" or "grossly negligent" in not knowing that 1.3 million shares constituted an "inadequate" float is untenable.

The Second Circuit has unanimously held that a party cannot be held liable in private suit for damages under Rule 10b-5 for mere negligent conduct. Lanza v. Drexel & Co., 479 F.2d at 1304; Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir. 1973), cert. denied, 414 U.S. 910, 924 (1974); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir. 1973), cert. denied, 414 U.S. 857 (1974); Shemtob v. Shearson, Hammill & Co., 448 F.2d at 445. Thus, plaintiff's allegations cannot state a Rule 10b-5 claim.

Plaintiff's Rule 10b-5 allegations are insufficient as a matter of law not only because they are predicated on negligence, but also because they allege mere inaction. In Lanza v. Drexel & Co., the Second Circuit, adopting language from Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971), stated:

> "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely on [sic] inaction. On the contrary, the only subsection that has any reference to an omission, as distinguished from affirmative action, is subsection (2) providing that it is unlawful 'to omit to state a material fact necessary in

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* The court below found that plaintiff has not even stated a claim for negligence. (A-21).

> order to make the statements made *** not misleading,' i.e., an omission occurring as part of an affirmative statement. . . . We perceive no reason, consonant with the congressional purpose in enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5 liability. . . ." 479 F.2d at 1300.

Since plaintiff has not alleged that defendants' omissions occurred as part of any actual representation made to the public, Lanza compels dismissal of the Rule 10b-5 allegations.

Plaintiff attempts, however, to bootstrap his Rule 10b-5 allegations by arguing that the specialist is in a "fiduciary relationship" with the class of short sellers and/or all potential investors in his stock. No such fiduciary relationship exists. The nature of a fiduciary relationship in the Rule 10b-5 context was described by the court in Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969), cert. denied, 397 U.S. 963 (1970), as a "relationship of trust and confidence exist[ing] between a dealer and his customer." Id. at 1240. In the present case, there is no allegation of a dealer-customer relationship nor of any specific reliance by the class of short sellers on the specialist's advice as to the adequacy of the float.

The official sources cited by plaintiff confirm that the only fiduciary duty owed by a specialist is that owed to his customers (i.e., those whose orders he keeps in

the "book") as broker.* Inasmuch as plaintiff does not contend that he was a customer of the specialist in his broker capacity (or rely upon such relationship), plaintiff's arguments based upon the specialist's fiduciary duties are inapplicable.

Moreover, even if Ramsay, Re owed a fiduciary duty to the investing public, the existence of such a duty would be irrelevant to the sufficiency of the Rule 10b-5 allegations. The existence of a fiduciary relationship does not overcome the general rule that mere inaction (even under the label of an "implied misrepresentation") cannot serve as the basis of a Rule 10b-5 claim.

The decision cited by plaintiff, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944) (involving the clear fiduciary relationship between a broker and his customer), does not negate the rule that a Rule 10b-5 claim cannot be based on mere inaction. First, Hughes is not a Rule 10b-5 case. Second, it does not involve mere inaction; rather, it involves a broker's omission to state a material fact in

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* For example, the SEC release cited by plaintiff (Plaintiff's Brief at 28) states that the specialist:

> "...is in a position of trust and confidence with his customers and obligated within the terms of his agency to the strict standards of loyalty, disclosure and fair dealings required of fiduciaries." (emphasis added) In the Matter of Re, Re & Sagarese, supra, [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,868 at 81,221.

connection with certain actual representations made to its customers. Specifically, Hughes involves a broker's omission to state the actual market price of a stock in connection with its direct solicitation of purchasing customers and advice to them concerning such stock. 139 F.2d at 436-37.

In the present case, unlike the situation in Hughes, there is no allegation of actual representations (much less direct solicitation) by Ramsay, Re to plaintiff or the investing public. Thus, even assuming that Ramsay, Re owed a fiduciary duty to the public, plaintiff cannot substitute mere inaction by Ramsay, Re (in place of the wilfully fraudulent solicitations and advice to customers involved in Hughes) as an "implied misrepresentation," actionable under Rule 10b-5.

Similarly, plaintiff's contention that the specialist is under a fiduciary relationship with the investing public does not, as plaintiff contends, obviate the need to allege scienter in Rule 10b-5 claims. Recent Second Circuit decisions adopting a "flexible duty" approach to Rule 10b-5 liability have "set a lower limit on the duty by requiring more than negligent conduct for liability to arise." White v. Abrams, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,457 at 95,608 (9th Cir. Mar. 15, 1974), citing Lanza v. Drexel, supra.

Plaintiff's reliance on the Hughes decision as negating the need for scienter is once more misplaced. Hughes involved specific findings of wilfully fraudulent conduct

on the part of the broker-dealer. Also misplaced is plaintiff's reliance on Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra. In Chris-Craft the court, while adopting the flexible duty approach, acknowledged that "mere negligent conduct is not sufficient to permit plaintiffs to recover damages in a private action under . . . § 10(b)." 480 F.2d at 363. Therefore, insofar as plaintiff has alleged mere inaction constituting at most negligence on the part of Ramsay, Re, plaintiff's novel assertion of a fiduciary duty cannot suffice to bolster his allegations into a sufficient Rule 10b-5 claim.

In summary, the court below was correct in holding that plaintiff has not stated a claim under Section 10(b) and Rule 10b-5.

POINT III

The Court Below Correctly Held That Plaintiff Has Alleged No Cause of Action Against Bear, Stearns Under Section 20 of the Exchange Act.

Plaintiff's conclusory allegation that Bear, Stearns "controls" Ramsay, Re (Complaint, ¶ 2(a)(iv), A-4), is not sufficient to confer subject matter jurisdiction under Section 20(a) of the Exchange Act. 15 U.S.C. § 78t(a) (1970). Section 20(a) is not an independent source of subject matter jurisdiction with respect to the claims asserted against Bear, Stearns.

Jurisdiction under Section 20(a) is dependent upon the existence of jurisdiction of an underlying cause of action against the controlled person.* As shown in Point I of this Brief, supra, the alleged claim against Ramsay, Re (the alleged controlled person) does not confer subject matter jurisdiction on the federal court under AMEX Rule 170 or Rule 177. Moreover, as shown in Point II of this Brief, supra, federal jurisdiction as to Ramsay, Re cannot be predicated on SEC Rule 10b-5. Inasmuch as the court below has no jurisdiction over the claims asserted against Ramsay, Re, it lacks jurisdiction with respect to the derivative claims asserted against Bear, Stearns.

POINT IV

Creation of Plaintiff's Proposed Right of Action Would Contravene Public Policy.

Plaintiff has asked this Court (1) to imply a legal duty on the part of a stock exchange specialist to inform the public of its opinion as to the adequacy of the float of a given stock, (2) to imply a legal duty on the part of the specialist to suspend trading when, in its opinion, such float is inadequate, and (3) to create a private right of

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* Section 20(a) is not operative unless the controlled person is "liable under any provision of this Chapter or of any rule or regulation thereunder . . . ." Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1970).

action under federal law against the specialist for breach of these implied duties. Sound policy reasons suggest that this Court reject plaintiff's requests.

A. The Existing Laws Are Adequate to Protect the Public from Impropriety on the Part of a Specialist.

In determining whether to imply a novel right of action under federal law, a court should examine the adequacy of the existing laws. Colonial Realty, 358 F.2d at 182-183. The existing laws are in fact adequate to protect the public from damage caused by impropriety on the part of a specialist.

If a specialist were to fail to "engage in a course of dealing for his own account to assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market" and thus violate AMEX Rule 170, he would be subject to the stringent sanctions set forth in AMEX Rule 170(b):

> "If the Exchange shall have found any substantial or continued failure by a specialist to engage in such a course of dealings, the registration of such specialist shall be subject to suspension or cancellation by the Exchange in one or more of the securities in which he is registered."

The AMEX has been particularly active in monitoring specialists and in suspending registrations for failure to comply with specialist rules*. Specialist Case Study at 28-29.

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* In the event the Exchange were to fail to exercise its supervisory powers (which is not the case at bar), the proper remedy would be against the Exchange, not the member firm. O'Neill v. Maytag, 339 F.2d 764, 770 (2d Cir. 1964). See also Colonial Realty, 358 F.2d at 181.

Moreover, if the specialist were to engage knowingly in a fraudulent scheme, the public would be further protected by the state law remedies for fraud, as well as by Rule 10b-5. The existing remedies are, therefore, adequate to preclude the necessity of this Court's implication of a new basis for federal liability of specialists under the rubric of Rules 170 and 177.

B. Creation of Specialists' Duties Is the Province of the SEC and the Stock Exchanges, Rather Than the Courts.

Imposition on the specialist of a duty to inform the public of its opinion as to the adequacy of the float in a given stock and to suspend trading when, in his opinion, such float is inadequate would involve a significant change in the existing law. Even if such a change were desirable, the SEC or the Stock Exchange, rather than the federal court, would be the appropriate forum to effectuate such a change.

The area of specialist regulation is particularly complex:

> "No issue has been more disputed than that centering about the function of the specialist." H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 14 (1934); 78 Cong. Rec. 7706 (1934).

Recognizing this complexity, Congress deferred to the expertise of the SEC and the Exchanges and delegated the task of defining the specialist's duties. See Exchange Act Sections 11(b) and (e), 15 U.S.C. § 78k(b) and (e) (1970). The SEC devised the

present specialist rules only after conducting a massive factual study (see SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker (1936)) and has continued to review the operation of these rules.* See, e.g., Exchange Act Release No. 1117 (1937); SEC, Special Study at 57-166. As noted above (pp. 15-16, supra), the SEC was aware of the complex and highly subjective nature of the duties imposed by these rules, agreed that civil liability for their violation would be "unwarranted," and attempted to preclude any possibility of such liability in drafting its Rule 11b-1. Specialist Case Study at 66-69. In lieu of such liability, the SEC retained authority to take disciplinary action against specialists for certain violations, as well as the right to make further changes in the rules. Id. at 68.

In view of the complexity of specialist regulation and the delegation to the SEC of the formulation of rules pertaining to specialists, the appropriate forum in which plaintiff should seek to effectuate a change in the specialist's duties is the SEC or the Stock Exchanges. As a lower court recently stated:

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* In addition, both the SEC and Congress have conducted extensive studies of institutional investment in the securities market. See Hearings on the Impact of Institutional Investors in the Stock Market Before the Subcomm. on Financial Markets of the Senate Comm. on Finance, pts. 1 and 2 (1973); SEC, Institutional Investor Report, Vols. 1-6 (1971).

> "If plaintiff wishes to influence or change Exchange policy, his remedy is to petition the SEC to exercise its powers under Section 19(b) of the Act to recommend changes in the Exchange Rules, or to alter or amend the rules." Independent Investor Protection League v. New York Stock Exchange, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,323 at 95,115. See also Far East Conference v. United States, 342 U.S. 570, 574 (1952).

C. Creation of the Proposed Right of Action Would Disrupt the Securities Market as Well as Further Inundate the Courts.

If this Court were to hold that plaintiff's allegations are actionable, the securities market would be disrupted and federal courts would be further overburdened.

A specialist would be obligated to suspend trading whenever he might suspect that the float in a given stock was inadequate, even though there is no standard (beyond the existing Suspension Guidelines which plaintiff's allegations establish were met) for determining such inadequacy. If the Levitz float, with 40% institutional holdings (2.2 million shares out of 5.6 million shares issued), were held to be so inadequate as to necessitate suspension of trading, then trading would have to be suspended in many large publicly held corporations, for current estimates place the institutional holdings in such corporations at 39.4% (as of 1970). Hearings on the Impact of Institutional Investors in the Stock Market Before the Subcomm. on Financial Markets of the Senate Comm. on Finance, pt. 1, Appendix E (SEC Findings

and Recommendations) at 387-388. Such judicial disruption of the securities market would be unprecedented.

Moreover, if this Court were to hold that federal courts have exclusive subject matter jurisdiction over claims such as the plaintiff's, the dockets of federal courts would be further congested. As a result of such a decision, any investor who had suffered a trading loss, regardless of amount, could bring an action in federal court against the specialist for failure to suspend trading.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the decision dated May 6, 1974 of the United States District Court for the Southern District of New York dismissing the complaint should be in all respects affirmed.

Respectfully submitted,

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APPENDIX

American Stock Exchange Rule 170:

(a) No member shall act as a specialist in any security unless such member is registered as a specialist in such security by the Exchange and such registration may be revoked or suspended at any time by the Exchange.

(b) As a condition of a member's being registered as a specialist in one or more securities, it is to be understood that, in addition to the execution of commission orders entrusted to him and the performance of his obligations as an odd-lot dealer (if he is so registered) in such securities, a specialist is to engage in a course of dealings for his own account to assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market on the Exchange in such securities in accordance with and when viewed in relation to the criteria set forth in paragraphs (c) and (d) of this rule and the commentary thereto. If the Exchange shall have found any substantial or continued failure by a specialist to engage in such a course of dealings, the registration of such specialist shall be subject to suspension or cancellation by the Exchange in one or more of the securities in which he is registered. Nothing herein shall limit any other power of the Board of Governors under the Constitution or any rule of the Exchange with respect to the registration of a specialist or in respect of any violation by a specialist of the provisions of this rule.

(c) A specialist or his member organization shall not effect on the exchange purchases or sales of any security in which such specialist is registered, for any account in which he or his member organization is directly or indirectly interested, unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market, or to act as an odd-lot dealer in such security.

(d) In connection with the function of a specialist in relation to assisting in the maintenance, insofar as reasonably practicable, of a fair and orderly market in

the securities in which he is registered, it is ordinarily expected that a specialist will engage, to a reasonable degree under the existing circumstances, in dealings for his own account in full lots when lack of price continuity or lack of depth in the full lot market or temporary disparity between supply and demand in either the full lot or the odd-lot market exists or is reasonably to be anticipated. Transactions on the Exchange for his own account effected by a specialist in the securities in which he is registered are to constitute a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable depth, and to the minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated, in either the full lot or the odd-lot market. Transactions in the securities not part of such a course of dealings are not to be effected by a specialist for his own account.

(e) No member (other than a specialist acting pursuant to paragraphs (c) or (d) above), limited partner, officer, employee, approved person or party approved pursuant to Article IV, Section 2(g) of the Constitution, who is affiliated with a specialist or specialist member organization, shall, during the period of such affiliation, purchase or sell any security in which such specialist is registered for any account in which such person or party has a direct or indirect interest. Any such person or party may, however, reduce or liquidate an existing position in a security in which such specialist is registered provided that such orders are (1) identified as being for an account in which such person or party has a direct or indirect interest; (2) approved for execution by a Senior Floor Official; and (3) executed by the specialist in a manner reasonably calculated to contribute to the maintenance of price continuity with reasonable depth. No order entered pursuant to this paragraph (e) shall be given priority over, or parity with, any order represented in the market at the same price. [2 CCH American Stock Exchange Guide ¶ 9310]

American Stock Exchange Rule 177:

Every specialist shall report to a Floor Official:

Unusual activity

(a) Any unusual activity or price change in a security in which he specializes;

Material information

(b) Any information which he receives which he believes may affect materially the business or financial structure of the issuer of, or the market in, a security in which he specializes;

Options

(c) Any information with respect to the existence of options or selling agreements with respect to the security in which he specializes; and

Unusual Transactions

(d) Any unusual transaction or transactions in which he participates as a broker or as a dealer in the security in which he specializes. [2 CCH American Stock Exchange Guide ¶ 9317]